Internal Revenue Service

memorandum

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Br1:HFRogers

date: APR 17 1990

to: District Counsel, Sacramento CC:SAC
Attn: Shelleyanne W.L. Chang

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: Estate of [redacted], Deceased,
[redacted], Administrator
Dkt. No. [redacted]

This is in response to your request for our tax litigation advice dated March 15, 1990.

ISSUES

1. Whether an estate is entitled to a deduction for interest under I.R.C § 2053 where, although the interest has accrued on the estate tax deficiency, there are insufficient funds left in the estate to pay the interest. 2053-0700

2. Whether attorney's fees and accountant's expenses incurred with respect to the audit of the Form 1041 are deductible as an administration expense on Form 706. 2053-0600; 2053-0700.

CONCLUSION

1. The estate is not entitled to a deduction for accrued interest that will not be paid. In the alternative, if the estate is entitled to a deduction for such interest, the interest must be included in the estate's income in the year in which it is established that the interest expense will not be paid.

2. The attorney's fees and accountant's expenses incurred by the estate with respect to the audit of its Form 1041 are allowable as a deduction for estate tax purposes because the waiver under section 642(g) has not been filed.

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FACTS

The decedent, [redacted], and her husband immigrated from Italy to the United States during the [redacted]'s. They acquired approximately [redacted] acres of land near [redacted], California, which they used for farming. After her husband's death in [redacted], title to the land was transferred to [redacted].

In order to operate the farm after the death of her husband, one of [redacted]'s brothers came from Italy to assist her in the early [redacted]'s. This brother was killed in an automobile accident. In [redacted], another brother, [redacted] arrived from Italy. [redacted] stayed with the decedent and helped to manage the farm until all of the land was sold in [redacted].

[redacted] and [redacted] returned to Italy in [redacted] where she died on [redacted]. Prior to her departure for Italy, decedent closed all but two of her bank accounts with the [redacted] and [redacted], taking with her over [redacted] dollars in cash. Decedent deposited the cash into the [redacted] in [redacted], Italy, account numbers [redacted] and [redacted]. Title of account number [redacted] was in the decedent's name along with her brothers [redacted] and [redacted]. Account number [redacted] was opened in the decedent's name along with [redacted] and the decedent's niece, [redacted].

The notice of deficiency was based on the amounts in the decedent's bank accounts before she left the United States in [redacted]. The estate argued that the gross estate should be reduced by one-half because [redacted] supplied part of the consideration for the cash in the bank accounts because of his long years of service on decedent's farm. Furthermore, documents obtained from Italy indicate that at the time of her death no money remained in the Italian bank accounts and that [redacted] died destitute.

The parties settled with respect to the amount of money left in the estate on the date of decedent's death. Still at issue is the amount of deductible administration expenses.

On [redacted], the estate made an advance payment of $[redacted] on the deficiency and, on [redacted], the estate made another payment of $[redacted]. After payment of the attorney's fees and accountant's expenses approved by the probate court, only $[redacted] remains in the estate's bank account. Thus, although the estate tax deficiency has been paid in full, there will still remain a balance due and owing for accrued interest on the estate tax deficiency.

The estate argues it is entitled to a deduction for the accrued interest, although it will never be paid by the estate. In addition, the estate claimed the interest earned from the [redacted] and [redacted] bank accounts was foreign source income. The Form 1041s are currently under examination on this issue. The estate is arguing that any accountant's expenses and attorney's fees incurred with respect to the audit of the Form 1041s should be allowed as an expense of administration on Form 706.

DISCUSSION

Section 2053(a) provides, in part, that in determining the value of a taxable estate, deductions shall be allowed for funeral expenses, administration expenses, and claims against the estate in such amounts as are allowable by the laws of the jurisdiction under which the estate is being administered.

Treas. Reg. § 20.2053-3(a) provides, in part, that the amounts deductible from a decedent's gross estate as administration expenses are limited to such expenses as are actually and necessarily incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it. The expenses contemplated in the law are such only as attend the settlement of an estate, and the transfer of the property of the estate. Administration expenses include (1) executor's commissions, (2) attorney's fees and (3) miscellaneous expenses.

Interest deduction

Interest on federal estate and state inheritance taxes is deductible. See Estate of Bahr v. Commissioner, 68 T.C. 74 (1977), acq. 1978-1 C.B. 1; Estate of Bailly v. Commissioner, 81 T.C. 246, supplemental opinion, 81 T.C. 949 (1983); Rev. Rul. 81-154, 1981-1 C.B. 470. The limit on these deductions is that only accrued interest will be allowed; unaccrued interest is not deductible. See Bailly, supra; Rev. Proc. 81-27, 1981-1 C.B. 548.

The Service's position is that the amount of the interest expense deduction should be the amount actually paid. This position is not free from doubt. Therefore, we recommend that this position be set up in the form of two alternative arguments. First, that only accrued interest which will actually be paid is deductible pursuant to section 2053. Second, even if accrued interest is deductible, once it becomes apparent the interest will not be paid it must be included in the estate's income.

We were unable to locate any cases that involved this administration expense issue. However, O.M. 19852, [redacted], I-221-84 (Oct. 4, 1984), sets forth the

Service's position that the amount of the deduction should be the amount actually paid. O.M. 19852 dealt with whether administration expenses should be discounted to their present value as of the date of the decedent's death.

O.M. 19852 looked at the language of certain of the treasury regulations to conclude that the deduction can only be for the amount actually paid or reasonably expected to be paid. Treas. Reg. § 20.2053-3(a) states:

> The amounts deductible from a decedent's gross estate. . . are limited to such expenses as are actually and necessarily incurred in the administration of the decedent's estate;. . . The expenses contemplated in the law are such only as attend the settlement of an estate and the transfer of the estate to individual beneficiaries or to a trustee,. . . Expenditures not essential to the proper settlement of the estate,. . . may not be taken as deductions. (Emphasis added).

Treas. Reg. §§ 20.2053-3(d) and 20.2053-3(c) provide that executors' commissions and attorneys' fees may be deducted in the amount "actually paid" or the amount that, at the time the estate tax return is filed, may reasonably be expected to be "paid." Further, Treas. Reg. § 20.2053-1(b)(3) allows a deduction for estimated expenses provided they are ascertainable with reasonable certainty and will be paid. Thus, it is apparent that the amount of the section 2053(a)(2) deduction is to reflect the amount paid in administering the estate. See also G.C.M. 36172, Foreign Death Taxes, I-6-74 (Feb. 28, 1975); G.C.M. 38219, Appropriate Exchange Rates to Use for Debts of a Decedent and Administration Expenses of an Estate, I-260-79 (Dec. 28, 1979).

O.M. 19781, [redacted], I-327-83, (Feb. 3, 1984) also discusses interest expense in the context of section 2053(a)(2). O.M. 19781 relies on Connecticut state law when it concludes:

> [T]he personal representative of a decedent's estate will not be required to pay interest in full if the estate does not have sufficient funds to pay interest after the debts and the charges of settling the estate have been paid. Consequently interest on federal estate tax deficiencies will not be allowable in full as an administrative expense if the estate is not solvent enough to first pay all debts and then pay all interest owing on these debts.

Thus, O.M. 19781 also stands for the proposition that an estate will only be entitled to an interest expense deduction for interest which is, in fact, paid.

Further, section 2053 expressly requires actual payment as a precondition to deduction of certain items. Section 2053(b) permits a deduction for expenses incurred in administering property not subject to claims if "such amounts are paid" before the statute of limitations expires. Section 2053(d)(1)(b) permits a deduction for death taxes "imposed by and actually paid to" foreign countries.

Additionally, it is apparent that post-death valuation is proper to determine the amount of administration expenses actually paid because administration expenses are necessarily post-death expenditures. See Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982), wherein the court held:

> Thus, the contents of section 2053 do not give rise to any inference regarding whether post death events should be considered when valuing claims against an estate. Moreover, except with regard to matters like funeral and administration expenses, which by their very nature require valuation after a decedent's death, Congress has been explicit in providing for consideration of post death events. (Emphasis added).

Thus, the fact that an administration expense will not be paid can be determined and the deduction disallowed under the section 2053 statutory scheme.

The Service further articulated this position in O.M. 19830, [redacted], I-090-84 (June 27, 1984). One of the issues in O.M. 19830 is whether Rev. Rul. 80-250, 1980-2 C.B. 278 is inconsistent with Rev. Rul. 82-6, 1982-1 C.B. 137. Rev. Rul. 80-250 disallows a deduction for unpaid unaccrued interest because section 2053 disallows a deduction for estimated expenses that are vague and uncertain. Rev. Rul. 80-250 points out that it is impossible to estimate the amount of future interest expense with any degree of accuracy. Rev. Rul. 82-6 involves the amount of a charitable deduction under section 2053. The charity was entitled to only a residuary bequest after all expenses had been paid out of the residue. Rev. Rul. 82-6 disallows a charitable deduction to the extent that a payment of interest expense could deplete the residue. O.M. 19830 concludes that it is one thing to estimate the maximum amount that might be diverted from charity and quite another to base a deduction for interest expense on a hypothetical amount that might never be paid. Section 2055 is concerned with estimating the maximum amount that might not be paid to charity, whereas section 2053 is

concerned with a reasonable estimate of the amount of interest that will be paid. (Emphasis in the original).

In Rev. Rul. 80-250, the Service announced that interest expense is deductible when the interest accrues. When the interest becomes deductible and the estate claims the deduction under section 2053(a)(2), the estate tax is recomputed. Rev. Proc. 81-27, 1981-2 C.B. 548 discusses the mechanism whereby the estate can claim the section 2053(a)(2) deduction. The estate must file a supplemental Form 706 to claim the interest expense deduction. However, Rev. Proc. 81-27 specifies that the supplemental Form 706 cannot be filed before the payment of the interest for which the deduction is claimed.

Based upon the statutory language, treasury regulations and Rev. Proc. 81-27, we have a strong position that the estate cannot take an interest expense deduction for interest that will not be paid. Section 2053 envisions a post-death approach that allows only expenses that are actually paid to be deducted from the gross estate.

Although we view the statutory scheme surrounding section 2053 as mandating that the estate cannot deduct administrative expenses which will not be paid, we foresee certain litigating hazards associated with this position. Therefore, we recommend that an alternative position also be argued.

In the case of United States v. Hughes Properties, Inc., 476 U.S. 593 (1986), the Supreme Court addressed whether an accrual basis taxpayer could deduct an accrued liability, even though it was not certain that liability would ever be paid. The Court concluded that the existence of an absolute liability is necessary under section 162 in order for an accrual basis taxpayer to deduct all ordinary and necessary expenses incurred during the taxable year in carrying on its trade or business. The Court further held that it was not necessary to have absolute certainty that the amount would be discharged by payment. This is consistent with the Service's pronouncement in Rev. Rul. 70-367, 1970-2 C.B. 37, which held that accrued interest could be deducted even though there was no reasonable expectancy that the accrual method taxpayer would pay the accrued interest in full. The Supreme Court concluded in Hughes Properties that, if the accrued liabilities were not paid, the deducted amounts would qualify as recaptured income subject to tax.

Thus, an alternative argument should be advanced that even if the accrued interest is deducted from the estate tax liability, the deducted amount must be included as income to the estate in the year it is determined that the interest expense cannot be paid.

Section 642(g)

Administration expenses are deductible under section 2053 in determining the taxable estate for estate tax purposes. In addition, under sections 165, 212 and 641, administration expenses, even though chargeable to the principal of the estate, are deductible in computing the taxable income of the estate for income tax purposes. There is no express statutory provision granting the executor the option to deduct these expenses and losses for either estate or income tax purposes. The option arises from the exercise of section 642(g), which states that no income tax deduction can be allowed for such expenses and losses unless a statement is filed that the expenses and losses have not been allowed as estate deductions and that all rights to have the expenses and losses allowed as estate tax deductions are waived.

Treas. Reg. § 20.2053-3(c)(2) provides that the estate is entitled to a deduction for attorney's fees paid in contesting an asserted deficiency. Treas. Reg. § 20.2053-3(d) provides a deduction for accountant's fees incurred in maintaining the property of the estate. A debate about whether the interest paid on the bank accounts was actually income to the estate involves questions essential to the settlement of the estate and, therefore, expenses incurred incident to this debate are deductible from the estate tax return.

G.C.M. 38811, [redacted], I-314-80 (June 16, 1981) and O.M. 19530, [redacted], I-276-81 (Jan. 6, 1982) discuss whether the estate is entitled to take accountant's expenses and attorney's fees on the estate tax return or on the fiduciary income tax return.

O.M. 19530 and G.C.M. 38811 involve the question of whether an estate can take section 2053 deductions from its estate tax return after already deducting these amounts on its income tax return. They conclude that, so long as the estate has not filed a waiver under section 642(g), the estate can take the deductions from its estate tax return. They conclude that the Tax Court was correct in stating that section 642(g) "begins with the premise that the deduction must be allowed for estate tax purposes, and provides that it may then be disallowed for income tax purposes. We are not free to reverse the specific scheme for avoidance of double deductions chosen by Congress." Estate of Baldwin v. Commissioner, T.C. Memo. 1959-203. See also Rev. Rul. 81-287, 1981-2 C.B. 183.

Thus, the estate should be entitled to deduct the administration expenses incurred in the audit of the Form 1041 from its estate tax return. However, since the estate has no funds, we assume that these administrative expenses will not be paid. For the reasons discussed above, we do not believe the estate is entitled to a deduction for amounts that will not be paid.

We have attached copies of the O.M.s discussed in this memorandum. They should not be cited or furnished to individuals working outside of the office of Chief Counsel. If you have any further questions, please contact Helen F. Rogers at FTS 566-3442.

MARLENE GROSS

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Enclosures:
O.M. 19530
O.M. 19781
O.M. 19830
O.M. 19852